

within the United States (as determined under paragraphs (c) and (d) of this section) and (ii) the expenses and deductions determined in accordance with this paragraph.

(2) *Interest and taxes.* Interest and income, war-profits, and excess profits taxes shall be excluded from the apportionment process, as indicated in paragraph (d) of this section; but, for the purpose of computing taxable income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest deductible under section 163 and of all income, war-profits, and excess profits taxes deductible under section 164, paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. The ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income, from such transportation service.

(3) *General expenses.* General expenses, losses, or deductions shall be deducted under this paragraph to the extent indicated in paragraph (d)(2) of this section.

(4) *Personal exemptions.* The deductions for the personal exemptions shall be allowed under this paragraph to the same extent as provided by paragraph (b) of § 1.861-8.

(5) *Special deductions.* The special deductions allowed in the case of a corporation by sections 241, 922, and 941 shall be allowed under this paragraph to the same extent as provided by paragraph (c) of § 1.861-8.

(g) *Allocation based on books of account.* Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which more clearly reflects the income derived from sources within the United States than does the process prescribed

by paragraphs (b) to (f), inclusive, of this section.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8687, 61 FR 60550, Nov. 29, 1996]

**§ 1.863-6 Income from sources within a foreign country or possession of the United States.**

The principles applied in §§ 1.861-1 to 1.863-5, inclusive, for determining the gross and the taxable income from sources within and without the United States shall generally be applied, for purposes of the income tax, in determining the gross and the taxable income from sources within and without a foreign country, or within and without a possession of the United States. This section shall not apply, however, to the extent it is determined by applying § 1.863-3 that a portion of the taxable income is from sources within the United States and the balance of the taxable income is from sources within a foreign country or possession of the United States. In the application of this section the name of the particular foreign country or possession of the United States shall be substituted for the term "United States", and the term "domestic" shall be construed to mean created or organized in such foreign country or possession. In applying section 861 and the regulations thereunder for purposes of this section, references to sections 243, 245, and 931 shall be excluded, and the exception in section 861(a)(3) shall not apply. In the case of any item of income, the income from sources within a foreign country or possession of the United States shall not exceed the amount which, by applying any provision of §§ 1.861-1 to 1.863-5, inclusive, without reference to this section, is treated as income from sources without the United States.

[T.D. 7378, 40 FR 45435, Oct. 2, 1975]

**§ 1.863-7 Allocation of income attributable to certain notional principal contracts under section 863(a).**

(a) *Scope—(1) Introduction.* This section provides rules relating to the source and, in certain cases, the character of notional principal contract income. However, this section does not apply to income from a section 988

transaction within the meaning of section 988 and the regulations thereunder, relating to the treatment of certain nonfunctional currency transactions. Notional principal contract income is income attributable to a notional principal contract. A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract, because a taxpayer cannot enter into a contract with itself.

(2) *Effective date.* This section applies to notional principal contract income includible in income on or after February 13, 1991. However, any taxpayer desiring to apply paragraph (b)(2)(iv) of this section to notional principal contract income includible in income prior to February 13, 1991, in lieu of temporary Income Tax Regulations § 1.863-7T(b)(2)(iv) may (on a consistent basis) so choose. See paragraph (c) of this section for an election to apply the rules of this section to notional principal contract income includible in income before December 24, 1986.

(b) *Source of notional principal contract income*—(1) *General rule.* Unless paragraph (b) (2) or (3) of this section applies, the source of notional principal contract income shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).

(2) *Qualified business unit exception.* The source of notional principal contract income shall be determined by reference to the residence of a qualified business unit of a taxpayer if—

(i) The taxpayer's residence, determined under section 988(a)(3)(B)(i), is the United States;

(ii) The qualified business unit's residence, determined under section 988(a)(3)(B)(ii), is outside the United States;

(iii) The qualified business unit is engaged in the conduct of a trade or busi-

ness where it is a resident as determined under section 988(a)(3)(B)(ii); and

(iv) The notional principal contract is properly reflected on the books of the qualified business unit. Whether a notional principal contract is properly reflected on the books of such qualified business unit is a question of fact. The degree of participation in the negotiation and acquisition of a notional principal contract shall be considered in this determination. Participation in connection with the negotiation or acquisition of a notional principal contract may be disregarded if the district director determines that a purpose for such participation was to affect the source of notional principal contract income.

(3) *Effectively connected notional principal contract income.* Notional principal contract income that under principles similar to those set forth in § 1.864-4(c) arises from the conduct of a United States trade or business shall be sourced in the United States and such income shall be treated as effectively connected to the conduct of a United States trade or business for purposes of sections 871(b) and 882(a)(1).

(c) *Election*—(1) *Eligibility and effect.* A taxpayer described in paragraph (b)(2)(i) of this section may make an election to apply the rules of this section to all, but not part, of the taxpayer's income attributable to notional principal contracts for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. A taxpayer not described in paragraph (b)(2)(i) of this section that is engaged in trade or business within the United States may make an election to apply the rules of this section to all, but not part, of the taxpayer's income described in paragraph (b)(3) of this section for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. If a taxpayer makes an election pursuant to this paragraph (c)(1) in the time and manner provided in paragraph (c) (2) and (3) of this section, then, with respect to such taxable years (or portion thereof), no tax shall be deducted or

withheld under sections 1441 and 1442 with respect to payments made by the taxpayer pursuant to a notional principal contract the income attributable to which is subject to such election. The election may be revoked only with the consent of the Commissioner.

(2) *Time for making election.* The election specified in paragraph (c)(1) of this section shall be made by May 14, 1991.

(3) *Manner of making election.* The election described in paragraph (c)(1) of this section shall be made by attaching a statement to the tax return or an amended tax return for each taxable year beginning before December 24, 1986, in which the taxpayer accrued or received notional principal contract income. The statement shall—

(i) Contain the name, address, and taxpayer identifying number of the electing taxpayer;

(ii) Identify the election as a “Notional Principal Contract Election under § 1.863-7”; and

(iii) Specify each taxable year described in paragraph (c)(1) of this section in which payments were made.

(d) *Example.* The operation of this section is illustrated by the following example:

(1) On January 1, 1990, X, a calendar year domestic corporation, entered into an interest rate swap contract with FZ, an unrelated foreign corporation. X does not have a qualified business unit outside the United States. Under the contract, X is required to pay FZ fixed rate dollar amounts, and FZ is required to pay X floating rate dollar amounts, each determined solely by reference to a notional dollar denominated principal amount specified under the contract. The contract is a notional principal contract under § 1.863-7(a) because the contract provides for the payment of amounts at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for a promise to pay similar amounts.

(2) Assume that during 1990 X had notional principal contract income of \$100 in connection with the notional principal contract described in (1) above. Also assume that the contract provides that payments more than 30 days late give rise to a \$5 fee, and that X receives such a fee in 1990. Under paragraph (b)(1) of this section, the source of X’s \$100 of income attributable to the swap agreement is domestic. The \$5 fee is not notional principal contract income.

(e) *Cross references.* See § 1.861-9T(b) for the allocation of expense to certain

notional principal contracts. For rules relating to the source of income from nonfunctional currency notional principal contracts, see § 1.9 88-4T. For rules relating to the taxable amount of notional principal contract income allocable under this section to sources inside or outside the United States, see § 1.863-1(c).

[T.D. 8330, 56 FR 1362, Jan. 14, 1991]

#### § 1.864-1 Meaning of sale, etc.

For purposes of §§ 1.861 through 1.864-7, the word “sale” includes “exchange”; the word “sold” includes “exchanged”; the word “produced” includes “created”, “fabricated”, “manufactured”, “extracted”, “processed”, “cured”, and “aged”.

[T.D. 6948, 33 FR 5090, Mar. 28, 1968]

#### § 1.864-2 Trade or business within the United States.

(a) *In general.* As used in part I (section 861 and following) and part II (section 871 and following), subchapter N, chapter 1 of the Code, and chapter 3 (section 1441 and following) of the Code, and the regulations thereunder, the term “engaged in trade or business within the United States” does not include the activities described in paragraphs (c) and (d) of this section, but includes the performance of personal services within the United States at any time within the taxable year except to the extent otherwise provided in this section.

(b) *Performance of personal services for foreign employer—*(1) *Excepted services.* For purposes of paragraph (a) of this section, the term “engaged in trade or business within the United States” does not include the performance of personal services—

(i) For a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States at any time during the taxable year, or

(ii) For an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or a domestic corporation, by a nonresident alien individual who is temporarily present in the United